C.D. Howe Institute

Benefactors Lecture, 2005

Tax Reform and Investment:
Will the US Sneeze?
Will Canada Catch Cold?

Charles E. McLure, Jr.

Senior Fellow, Hoover Institution, Stanford University

Toronto, November 3, 2005

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Foreword

In the past decade and half, many countries have reduced taxes on saving in favour of expanding the taxation of consumption, either by relying on new sales taxes, such as the value-added tax (VAT), or by increasing limits on contributions to tax-free saving plans. The Netherlands and some Scandinavian countries, for example, introduced dual-income taxes that resulted in sharply lower taxes on investment and corporate income, while Australia replaced its wholesale tax with a VAT and reduced income taxes.

In the United States, a panel appointed by President George W. Bush to examine tax reform will publish the report of its findings while this volume is in press. That report will focus on the need for the United States to simplify its tax system, including shifting the tax burden from income to consumption, whether in the form of a sales tax like the VAT or a new kind of personal and business taxation that exempts investment income from tax.

In the light of impending major tax reform in Canada's largest trading partner, the C.D. Howe Institute is pleased that Professor Charles E. McLure, Jr., Senior Fellow of the Hoover Institution at Stanford University, has agreed to deliver this year's Benefactors Lecture. Professor McLure was instrumental in developing the 1984 tax reform study by the US Department of the Treasury that led to the US tax reform of 1986, and is thus well placed to present a review of US tax developments that could have major impacts on Canada.

In this Benefactors Lecture, Professor McLure surveys tax reforms that have taken place in various countries in recent years, and outlines some of the reforms that are under consideration in the United States and the effect these might have on Canada. He suggests that Canada need not simply react to US reforms but instead should move to implement a tax system that is simpler, more efficient, and fairer than the regime now in place.

I wish to thank Professor McLure for his keen insights. I am also grateful to Steve Letwin and Enbridge Inc. for sponsoring this year's Benefactors Lecture. Special thanks go to Bill Robson, who did much to ensure the success of the publication. Thanks also to several commentators, including George Zodrow of Rice University, Rosanne Altshuler of the US Tax Reform Panel, Jonathan Kesselman, and Finn Poschmann. The Institute also gratefully acknowledges the excellent editing of Barry A. Norris and the preparation of the manuscript for publication by Wendy Longsworth and Diane King.

The C.D. Howe Institute's aim in presenting the Benefactors Lecture series is to raise the level of public debate on issues of national interest by presenting diverse points of view. In doing so, the Institute hopes to give Canadians much to think about, including information they need to exercise their responsibilities as citizens. As with all C.D. Howe Institute publications, the opinions expressed here are those of the author, and do not necessarily represent the views of the Institute's members or Board of Directors.

Jack M. Mintz
President and Chief Executive Officer
C.D. Howe Institute

Recent years have seen remarkable changes in the way we think about and impose taxes on income from capital. Countries around the world have dramatically reduced taxes on capital income, and academic thought has shifted from favouring equal taxation of all income to favouring taxation of only labour income or only income that is consumed.

With the release of the report of the Advisory Panel on Federal Tax Reform that US President George W. Bush appointed in January 2005, the United States is likely to resume its debate on fundamental tax reform. How that debate plays out could have significant implications for Canada. When the United States broadened its tax base and lowered its tax rates in 1986, it virtually forced many countries to take similar actions (see Tanzi 1987, 1988; and Whalley 1990a,b).

In this paper, I review some of the recent changes in the way income from capital is taxed and in academic thinking about how we ought to tax that income. I also examine some of the options being discussed south of the border, including possible recommendations of the Advisory Panel, and their implications for Canada.

How We Tax Income from Capital

Until recently, most academic tax experts believed that, as a matter of principle, all income — whether derived from labour or from capital and whether consumed or saved — should be taxed equally. Practical problems of implementation, however — such as the need to tax on the basis of realization, rather than accrual — impeded achievement of this goal. Also, countries around the world commonly resorted to preferential tax treatment of selected economic activities, including targeted investment, pension saving, and housing.

During the 1980s, there was a widespread movement to scale back tax preferences and reduce tax rates in order to make income taxation simpler, more equitable, and less distortionary. When I was at the US Treasury Department during the preparation of the reports to President Ronald Reagan that led to the *Tax Reform Act of 1986*, I described the proximate objective of this kind of tax reform as "taxing all income uniformly and consistently, without regard to its source or use." Rate reduction reduces the economic damage caused by remaining distortions in the tax system. It also yields the

* The author acknowledges comments by Jonathan Kesselman, Jack Mintz, Finn Poschmann, Bill Robson, and George Zodrow on earlier drafts. The opinions expressed should, of course, be attributed only to the author.

bonus of protecting revenues, by making it less attractive to use transfer pricing and financial arrangements to shift taxable income out of the country and shift tax deductions in. The latter consideration may have been an important motivation for tax reform in many countries, including Canada.

Deviations from a Comprehensive Income Tax Base in the United States

Consumption and saving — and, of course, payment of taxes — are the only possible uses of pre-tax income. Academics, especially advocates of equal taxation of all income, use this identity to define a "comprehensive income tax base" as the sum of resources used for consumption and saving. The shorthand name for this concept is the Haig-Simons definition of income, after the two US economists who formulated it. (For a while, "Carter" was added to reflect the principled approach taken by Canada's Royal Commission on Taxation in the 1960s, commonly called the Carter Commission.)

Before proceeding further, it may be useful to catalogue some important ways that US taxation of income from capital deviates from the Haig-Simon definition of income, despite the 1986 tax reform, since they condition the current debate over tax reform.

First, like Canada, the United States allows a tax deduction for contributions to special retirement accounts, and taxes income saved in this way, along with earnings thereon, only when it is withdrawn. The United States also has a scheme — "prepaid" individual retirement accounts, or so-called Roth IRAs — in which, although there is no deduction for retirement savings, all subsequent withdrawals during retirement are exempt from federal income tax.[1]

Second, capital gains are taxed only when realized, rather than as they accrue, gains on assets held for more than one year are taxed at preferential rates of no more than 15 percent, and gains on assets transferred at death escape tax entirely.

Third, individual and corporate income taxes are not integrated. Rather, since 2003, dividends are subject to a maximum rate of 15 percent, well below the top rate on income other than long-term capital gains.

Fourth, there is no adjustment for inflation in the measurement of income from capital; thus, real interest income and interest expenses and capital gains are overstated, and real depreciation allowances are understated.

1 Kesselman and Poschmann (2001) propose that Canada adopt a similar provision. Such a scheme was under consideration, according to the 2003 federal budget, and the Conservatives included a version of it in their 2004 election platform.

Although the lack of inflation adjustment is not a major problem at current low rates of inflation, during the rapid inflation of the early 1980s it caused substantial distortions and inequities.

Fifth, like most countries, the United States does not tax imputed income from housing or consumer durables, but it nonetheless allows a deduction for mortgage interest, including a limited amount of interest on home equity loans. Disallowing this mortgage interest deduction, as Canada has done, would reduce the tax subsidy to homeownership, but only for those with mortgages; the return to equity in owner-occupied homes would remain tax free.

Sixth, interest on state and local government debt is excluded from the federal income tax base.

Seventh, interest received by not-for-profit organizations, including pension funds, is not taxable.

Eighth, deductions are allowed for most important state and local taxes and for charitable contributions.

Finally, the United States has a parallel income tax system, the alternative minimum tax (AMT), originally enacted in 1969, which, by subjecting certain tax preferences to tax, was intended to prevent high-income taxpayers from escaping all obligation to pay tax. In 1986, however, the AMT morphed into a tax that now affects few high-income taxpayers but applies to increasing numbers of lower-income taxpayers, many of whom may not even know it exists until they are hit with penalties and interest for not paying it (see Burman, Gale, and Rohaly 2003). The Advisory Panel on Federal Tax Reform estimates that the AMT will affect 20.5 million taxpayers in 2006 and 51.3 million (or 45 percent of all taxpayers with income) in 2015 (see United States 2005a). Such a system cannot be justified under any rational analysis, and there is widespread agreement that the AMT must be eliminated or "fixed." But fixing the AMT in a revenue-neutral tax reform — the only context that makes sense, given current and projected budget deficits — will make it virtually impossible to do much else that involves cutting taxes.

Ad Hoc Consumption-Based Taxation

Another way to tax income from capital is to base taxation on consumption. Such consumption-based taxation commonly includes three components:

- the expensing or immediate write-off of all investment, including that in depreciable and depletable assets, research and development, advertising, and additions to inventories;

- either a deduction for saving, with full taxation of principal and interest upon withdrawal, or exemption of the return to saving;
- either inclusion of the proceeds of borrowing in the tax base, with deductions of repayments of interest and principal, or disallowance for interest deductions.

A standard theorem of economic analysis is that, with expensing, the return to an equity-financed marginal investment — one that barely covers the cost of capital — is effectively tax exempt; in other words, the marginal effective tax rate (METR) is zero.[2] By comparison, if deductions for depreciation and similar income tax allowances reflect economic reality, the METR equals the statutory tax rate. Expensing is thus more favourable to investment than is economic depreciation.

Many who favour a more investment-friendly tax policy urge the adoption of expensing, without mentioning — or at least without advocating — its logical companion, which is either to allow no deductions for interest expense or to include the proceeds of borrowing in the tax base. If expensing is introduced without these companion measures, corporations and other business entities will face METRs that are negative and may pay little or no income tax. Indeed, they may eventually accumulate net operating losses that they cannot use to offset other income.

Just such a scenario occurred in the United States in the early 1980s, when the combination of accelerated depreciation and investment tax credits was even more generous than expensing, and fully deductible interest payments were bloated by inflation. The congressionally approved scheme for selling unusable tax benefits, called "safe harbor leasing," fuelled tax shelters and allowed even more corporations to "zero out" their tax liabilities. This spectacle was so distasteful that it helped fuel the tax reform in 1986 that eliminated both accelerated depreciation and the investment tax credit. Even so, in 2002, in an effort to encourage economic recovery following the terrorist attacks of September 11, 2001, Congress enacted a temporary 30 percent bonus first-year deduction for depreciation of equipment, which it boosted to 50 percent the following year. Gordon and Slemrod (1988) esti-

2 The METR is the percentage difference in the before- and after-tax returns to capital invested in a "marginal" project, one that is barely worth undertaking in the absence of taxation. In calculating the METR, one needs to consider all aspects of the tax system that impinge on the after-tax return to capital, including depreciation allowances, inventory accounting, rules for the deduction of interest, whether and how the measurement of income from capital reflects the effects of inflation, tax credits, capital taxes, and sales taxes on capital goods, as well as the statutory business income tax rate. Depending on the context, one may also consider the taxation of interest, dividends, and capital gains at the individual level or taxation in the home country of foreign investors. For further explication, see Chen (2000).

mate that, in 1983, US taxation of capital income raised virtually no revenue. Gordon, Kalambokidis, and Slemrod (2004) find that, by 1995, substantially more capital income was being taxed, largely due to the Tax Reform Act of 1986 and a reduction in nominal interest rates. By 2004, however, because of the Bush administration's 2002 and 2003 tax cuts, little income from capital was being taxed (see Gordon et al. 2004).

The practice of introducing expensing and other attributes of a consumption-based tax — for example, preferential treatment of pension savings and preferential rates for capital gains and dividends — into what is ostensibly an income tax, with no limitations on the deductibility of interest, is what I call the "ad hoc approach." Many countries have adopted investment incentives and ad hoc provisions to encourage saving, especially for retirement, that are more consistent with a consumption-based tax than with a pure income tax.

Rate Reduction

There are a number of reasons for not "taxing all income uniformly and consistently."[3] First, it is not easy to achieve uniform and consistent taxation, and in its absence there are opportunities for tax evasion and tax arbitrage.[4] Second, the economic arguments that justify consumption-based taxation imply that the normal return to capital — but not economic rents, the returns to existing capital, risk premiums, and the results of good fortune — should be exempt. Third, economic theory suggests that, in a highly globalized world in which capital moves in response to small differences in rates of return, the optimal rate of tax on income from capital for a small economy that is "open" to capital flows is zero.[5] Thus a small country may "shoot itself in the foot" by taxing capital income as heavily as it taxes labour income.

There is, of course, a more direct way to lower effective tax rates than by using expensing and other ad hoc methods: one can simply reduce statutory tax rates on income from capital. For example, many of the newest members of the European Union — such as Cyprus, Latvia, Lithuania, Hungary, Poland, and Slovakia — have statutory corporate tax rates in the range of 10 to 19 percent, well below the rates of 28 to 38 percent that prevail else-

3 See Boadway (2004) for an excellent summary of such reasons.

4 Tax arbitrage occurs when an investor pays tax-deductible interest to finance a tax-preferred investment.

5 See, for example, Gordon (1986); and Razin and Sadka (1991).

where in the EU.[6] Of course, most of these new EU members are small and many are just emerging from socialism, so they might not pose much of a direct competitive threat. But the indirect threat could be substantial if larger EU countries such as France, Germany, and Italy were to reduce their tax rates in order to remain competitive, and especially if the United States were to follow suit.[7]

Some countries, most notably Finland, Norway, and Sweden, have adopted "dual income taxes," whereby income from capital is taxed separately from other income, ordinarily at the lowest of the graduated rates applied to other income. Such tax systems usually include some form of integration of individual and corporation taxes, a task that is simplified by equating the corporate income tax rate and the tax rate on capital income. Under such systems, there is an incentive (especially for owners of closely held businesses) to characterize highly taxed labour income as capital income, and the risk that overzealous efforts to prevent this abuse will cause some capital income to be overtaxed as labour income (see Cnossen 1999, 536-41, and references therein.)

Integration

Under an ideal income tax, corporations would be treated like partnerships for tax purposes — as conduits through which earnings on equity investments would pass tax free, to be taxed in the hands of shareholders, whether distributed or not. Such integration would assure that equity finance is not penalized relative to debt finance, and that corporate-source income is not taxed more heavily than other income — a feature that is important for capital formation as well as for economic neutrality and horizontal equity. By comparison, under the so-called classical system, retained corporate-source income is taxed at the corporate rate, rather than at the tax rates of shareholders, and dividends are subject to double taxation, first at the corporate level and again at the shareholder level when distributed. Also, some countries tax capital gains, including gains that reflect retained earnings.

Partnership treatment, however, has long been considered administratively infeasible. Instead, many countries provide some form of "dividend

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6 An exception among older EU members is Ireland, which imposes a tax rate of just 12.5 percent. Other new members, however, have corporate tax rates that are more in line with those of "old Europe" — for example, in the Czech Republic, it is 26 percent; in Estonia, 24 percent, but only on distributed profits; in Malta, 35 percent; and in Slovenia, 25 percent. (See Ernst & Young 2005.)

7 For evidence on tax competition in the EU, see Zodrow (2003).

relief" in order to reduce or eliminate double taxation of distributed corporate-source income.[8] The most common form of dividend relief is an "imputation system," under which the income tax paid on corporate income that is distributed is seen as a withholding tax, for which shareholders are allowed a partial or complete credit.[9]

In Canada, "do-it-yourself" integration has been introduced recently through the use of income trusts. A tax-free income trust raises capital by issuing trust units and uses the proceeds to make both debt and equity investments in an operating company. Interest payments wipe out most, if not all, of the operating company's tax base. Alternatively, the trust may buy the assets of a company, instead of its stock, and lease the assets back, with lease payments offsetting the operating company's income. This technique has the additional advantage that capital owned by the income trust is not subject to capital tax. As the income trust is a flow-through entity, interest, dividends, and lease payments are taxed at the rates applicable to the holders of trust units. Aggarwal and Mintz (2004) find that unit trusts are found primarily in mature and slow-growing sectors, rather in the more dynamic sectors where investment would be most socially productive.

In the United States, the classical system has long withstood the onslaughts of those who favour integration. In 2003, however, a crude form of partial integration was introduced when the top individual income tax rate on dividends and long-term capital gains was limited to 15 percent.[10]

In the EU until recently, most members used imputation systems that provided credits to domestic shareholders only for taxes paid by corpora-

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8 See McLure (1979) and United States (1977, 1992). The neutrality and equity benefits of introducing dividend relief into a classical system depend on whether one adopts the "old" or the "new" view of the taxation of dividends. The old view holds that dividend relief furthers both horizontal equity and neutrality. The new view emphasizes that, once funds are invested or earnings are retained, the tax on dividends must be paid, no matter when dividends are paid, and thus it does not distort corporate decisions. Moreover, if corporate shares have been bought in expectation that the dividend tax must be paid, introducing dividend relief merely creates windfalls to owners of existing shares. (See Zodrow 1991; and United States 1992.) Of course, the existence of an unintegrated corporate income tax also distorts other choices, such as the form of executive compensation and incentives for acquisitions and their financing.

9 The most sophisticated systems of dividend relief tie relief to the amount of tax the corporation actually pays. In Canada, however, for federal tax purposes Canadian shareholders include 125 percent of dividends in taxable income and are allowed a credit equal to 13.33 percent of that amount, whether or not the dividends are paid from income that has been taxed at the corporate level.

10 Such a limit is a crude form of integration because, considering both corporate and individual income taxes, dividends are not taxed like other income, as under a system that allows full shareholder credits for the corporate income tax or one that allows corpor ...

tions resident in the particular member state. In a series of recent cases, the European Court of Justice has declared that imputation systems that limit relief in this way violate the freedom of movement of capital guaranteed by the EU Treaty. As a result, EU members have been abandoning imputation systems in favour of systems of dividend relief that are not based on taxes paid by local corporations, for example, by taxing dividends at reduced rates, or, in some cases, by adopting the classical system.[11]

Rethinking Taxes on Income from Capital

Even as these tax reforms are occurring, many academics argue that "taxing all income" is not a good idea — that it would be better to tax only income that is not saved, which, by definition, is income that is consumed.[12] Under certain circumstances, exempting income from capital at the individual level is economically equivalent to allowing a deduction for savings — that is, to taxing consumed income.[13] Thus, I follow the general practice among economists of treating a tax that exempts capital income, as does the well-known flat tax, as a consumption-based tax.

The cash flows of individuals may be treated in two different ways. In the first case, assets may be placed in "qualified accounts" or designated as being subject to consumed income tax treatment — that is, saving is deductible and tax on earnings is postponed, but all withdrawals of principal and interest are taxed; in effect, tax is "post-paid." In the second case, saving is not deductible, but investments yield tax-exempt income, so that tax is said to be "pre-paid." Analogous treatment can, of course, be applied to corporations and other businesses.

It was long believed that it would be more complicated to tax consumption than income because of the need to account for saving. In an influential 1974 article, however, Harvard Law School's Bill Andrews questioned

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footnote 10 con't

...ations a deduction for dividends paid. Also, imputation systems commonly allow shareholder credits only for dividends that have been subject to corporate taxes. President Bush's initial proposal, but not the legislation actually enacted, contained an analogous limitation. These reforms may, alternatively, be seen as ad hoc shifts toward a consumption-based tax.

11 See European Commission (2002, 300-02); Ilhi et al. (2003, 88-95); Mintz (2003); and Vann (2003).

12 For economic arguments in favour of consumption-based taxation, as well as further references, see Zodrow and Mieszkowski (2002); Slemrod and Bakija (2004); and Zodrow (2005).

13 For an intuitive demonstration of this proposition, see Kesselman and Poschmann (2001).

that view, arguing that simplifications inherent in consumption-based taxation would eliminate complications such as the distinction between capital gains and other income, distinctions between types of interest payments, the need for depreciation allowances and inventory accounting, and most other "timing" issues, such as when income is taxed and expenses are deductible.[14]

Many economists have emphasized that consumption-based taxation would eliminate the bias against future consumption inherent in income taxation and thus would be more conducive to capital formation. But not all agree; as Samwick (1998), Bernheim (1996; 2002), and others argue, "target savers" — those who want to set aside a given amount for precautionary reasons or for some future expenditure — may actually save less if saving is treated more favourably. Still others note that the essential differences in the bases of a comprehensive income tax and a comprehensive consumption-based tax are so small that shifting from one tax to the other would have only a modest effect on the rate of saving. Of course, as noted earlier, the base of the US income tax is far from comprehensive, especially where income from capital is concerned. Thus, most of the benefits of a comprehensive consumption-based tax could be achieved by reforming the current US income tax.[15]

A key determinant of how such a tax reform would affect saving is the treatment accorded wealth that existed at the time of the reform. If existing wealth were subject to tax, the beneficial effects on saving would be much greater than if it were exempt. Of course, this choice has implications for equity, as well as for saving. Those who have saved after-tax income in the expectation of consuming it during retirement without paying further tax

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14 One important timing issue would remain, however, especially under the income-exemption, or pre-paid, approach. Because business taxpayers may immediately deduct all expenditures, net operating losses are likely to be much more prevalent than under an income tax. Thus, in order to realize the economic neutrality benefits of consumption-based taxation, it is necessary either to pay refunds or to allow net operating losses to be carried forward with interest. This issue is likely to be less important under a post-paid, cash-flow tax because the tax base includes the proceeds of borrowing.

15 To show the similarity between income and consumption-based taxes, Hubbard (1997; 2002) compares a consumption-based, subtraction-method, value-added tax that allows expensing (and a deduction for wages) with a tax that is identical except that it allows economic depreciation, rather than expensing (the comprehensive business income tax the US Treasury Department examined in 1992). As Hubbard explains, the return to capital consists of three elements, aside from returns to "old" capital, which would be taxed under both schemes: the risk-free return to capital; "inframarginal" returns to ideas, managerial skill, and monopoly power; and the premium for investing in risky assets. Only the first of these would be treated differently under a consumption-based tax than under an income-based tax. See also Gentry and Hubbard (1997).

are not likely to take kindly to the notion of being taxed on this wealth. Transition rules that would moderate the confiscatory impact of taxing pre-existing wealth, besides reducing the salutary effects on saving, would introduce complexity and opportunities to "game the system" (see Zodrow 2002).

Much of the early US discussion of consumption-tax options proceeded as though the United States were a closed economy — that is, as though a tax reform that encouraged saving would increase investment by an equal amount. In an increasingly globalized world economy, however, this is not necessarily true. An increase in saving might leak out into foreign investment, and an increase in investment might be financed by capital inflows from abroad, rather than by domestic saving. Early evidence suggested that the link between saving and investment in the United States was fairly close, but that link seems to have become looser over time (see Ballard 2002). Thus, it makes sense to consider the effects of tax policy on saving and investment separately, especially in Canada.

Much that has been written about the distributional effects of a shift to a consumption-based tax is confusing or contradictory. Opponents of such taxation tend to focus on the taxes that taxpayers with various levels of income would pay under the two tax regimes, emphasizing that the posited reduction in taxes on capital income would reduce taxes on the more affluent, who generally save more, and increase them on lower-income taxpayers.

Advocates of consumption-based taxation respond in several ways. First, they argue that the lack of a significant difference between an income tax base and a consumption tax base implies that the distributional effects are not nearly as great as is suggested by simply assuming that a consumption tax would exclude all capital income from the tax base.

Second, proponents argue that one should not focus on tax burdens, relative to income, in a given year, since current income might not reflect the taxpayer's long-run status — because he or she is, for example, young and uneducated or inexperienced, temporarily unemployed, or retired. Rather, they suggest, it is more appropriate to consider tax burdens over the individual's lifetime.[16] Seen in that light, taxing consumption is preferable to taxing income, because the present value of taxable consumption over a lifetime, compared with the present value of lifetime income, does not depend on when income is earned or when it is spent. Moreover, any undesirable distributional effects would be muted. Finally, advocates argue, any unwanted shifts in the distribution of tax burdens could be avoided by altering the

16 See, for example, Fullerton and Rogers (1996); and Feenberg, Mitrusi, and Poterba (1997).

rate schedule to maintain distributional neutrality, as Bradford (2004) proposes.

Advocates of a flat tax cannot, of course, hide behind the last of these arguments. The flattening of the tax rate, which is inherent in the flat tax proposal, would greatly accentuate the redistribution of tax burdens that results from removing savings (or the normal return to capital) from the tax base. Indeed, by one estimate, flattening income tax rates would reduce the tax burden on US taxpayers who report incomes in excess of $200,000 by almost three-fourths as much as adopting a flat-rate, consumption-based tax that yielded the same revenue (Mieszkowski and Palumbo 2002, 175–76).

The Taxation of Income from Capital in Canada

Before discussing US thinking about tax reform and what those thoughts might imply for Canada, I would like to share a few observations about the taxation of income from capital in Canada.[17]

Both Canada's statutory corporate tax rate and its marginal effective tax rates are high by international standards. Of the 30 member countries of the Organisation for Economic Co-operation and Development, only six have generally applicable statutory rates that exceed Canada's rate of 35 percent. As noted earlier, for a given level of real economic activity, high tax rates create incentives for multinational enterprises to shift deductions into Canada and shift taxable income out, thereby artificially reducing their Canadian tax bases and tax liabilities. Thus, it might be possible to reduce tax rates with relatively little adverse effects on revenues.

High tax rates on economic income also reduce a country's attractiveness as a place to invest. But, since taxable income rarely corresponds to economic income, statutory rates alone are not a reliable indicator of the investor-friendliness of a country's tax system. Of more importance are marginal effective tax rates, and here Canada's METR of 39 percent in 2005 is exceeded only by China's.[18] In the United States, the rate is 38 percent and in Mexico, a mere 17 percent. In the nonrenewable resources sector — principally, mining and oil and gas — the disparity in the US and Canadian METRs is much greater, but in the opposite direction, since Canada taxes

17 In this section, I have relied on the C.D. Howe Institute for many of the statistics and their interpretation; see, especially, Chen and Mintz (2005a).

18 Recent calculations by Duanjie Chen (in Mintz, 2005) indicate that the METR on investment by large nonresource companies in Canada would average less than 29 percent if only federal and provincial corporate income taxes were considered. But capital taxes and sales taxes on capital goods add more than ten percentage points, bringing the total METR up to 39 percent.

that sector, particularly expenditures on exploration and development intangibles, very lightly.

If Canada were to reduce its corporate income tax rate, as proposed in the 2005 federal budget, and if the United States were to decide not to reinstate bonus depreciation, the gap between the two countries' METRs would mostly disappear. Canada's would stand at 37.3 percent, compared to a US figure of 37.0 percent. Of course, these rates might never materialize, especially if the United States were to undertake fundamental tax reform.

Canada's high METR can be traced to three causes, aside from its statutory tax rate. First, both depreciation allowances and inventory accounting are less advantageous than in the United States. Second, both the federal and provincial governments impose capital taxes; the United States has no counterpart, although state governments impose franchise fees (a form of low rate capital tax).[19] Third, although most US states and half of Canada's provinces levy defective retail sales taxes that include in the tax base many business purchases, the sales tax burden on capital goods is somewhat higher in Canada than in the United States.

US Thinking about Taxes on Income from Capital

Given the increasing academic interest in consumption-based tax systems, the widespread proliferation of ad hoc consumption-tax features, and the reduction of statutory tax rates and introduction of dual income taxes in various countries, Canada should consider whether and how it should reduce its taxation of income from capital. As noted, both Canada's statutory tax rate and its marginal effective tax rate on income from capital invested in many sectors are relatively high, which discourages investment, retards innovation, and causes both the productivity and incomes of Canadian workers to be lower than they could be.

Another important reason for Canada to consider reducing its taxation of income from capital is the looming possibility of tax reform in the United States. President Bush has said that he intends to reform the US income tax system during his second term. If adopted, US tax reform would have important implications for Canada's competitive position vis-à-vis the United States, but even if that country eschews reform, the US debate could provide a useful menu of options for Canada to consider.

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19 In both countries, subnational governments levy property taxes that are far higher than can be justified as covering the costs of public services provided to business taxpayers. Such taxes are levied primarily on real property, however, and thus have little effect on investment in equipment.

The terms of reference of any upcoming US debate on tax reform are likely to be set by the words President Bush used in establishing the Advisory Panel:[20]

> The purpose of the Advisory Panel shall be to submit to the Secretary of the Treasury...a report with revenue neutral policy options for reforming the Federal Internal Revenue Code. These options should:
>
> (a) simplify Federal tax laws to reduce the costs and administrative burdens of compliance with such laws;
>
> (b) share the burdens and benefits of the Federal tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society; and
>
> (c) promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace.

One can distinguish four generic types of tax reform the United States might consider:

- it might replace the federal income tax (and perhaps other federal taxes) with some form of general sales tax, such as a retail sales tax (RST) or a value-added tax (VAT);
- it might introduce a general sales tax as an additional source of revenue;
- it might replace the income tax with a conceptually sound, consumption-based direct tax; or
- it might "muddle through," by making marginal changes to the present income tax, some of which would move the system in the direction of a consumption-based tax, but in an ad hoc manner.

Below, I briefly consider each of these options, the likelihood of its being adopted, what its adoption would mean for Canada, and its desirability as an option for Canada whether or not the United States were to adopt it. In doing so, I look at only structural aspects of tax reform conducted in a revenue-neutral context. That is, I do not consider whether the level of taxes should be changed in either country. Also, I focus on the taxation of income from capital, and discuss other aspects of the taxation of individuals only to the extent necessary to understand and appraise the political viability of the proposal. These limitations are quite important, since many in the United States (such as Peterson 2004) would argue that deficit reduction should be given top priority, that reform of the alterative minimum tax should top the

20 See the Internet web site: http://www.taxreformpanel.gov.

list of tax reforms, and that simplification of the individual income tax is a driving force behind the demand for tax reform, if any such demand exists.

Replacing the Federal Income Tax with a Retail Sales Tax

Some conservative groups in the United States would replace the federal income tax and payroll taxes with a retail sales tax. The most-often stated objective is to get the Internal Revenue Service (IRS) out of people's lives.[21] It would be fascinating to play out the full implications of this policy, but I do not think it would be productive. I doubt that the United States will replace its entire federal income tax with a sales tax any time soon, if ever, for a number of reasons.

First, the sales tax has long been considered the exclusive fiscal preserve of state and local governments.

Second, rebates could be designed to avoid increasing the tax burden on low-income families, but they would not prevent a massive shift of the burden from the wealthy to the middle class. Feenberg, Mitrusi, and Poterba (1997) estimate that taxpayers with consumption in excess of US$200,000 in 1991 would pay one-third less tax under such a scheme. I presume that is why its wealthy supporters like it.

Third, eliminating the federal income tax would not simplify life for ordinary taxpayers, unless state and local income taxes were also eliminated. If there were no federal income tax, each of the 45 states that impose income taxes would need to put in place a bureaucracy to do what the IRS now does for it.

Fourth, it has been estimated that the sales tax rate that would be required to compensate for elimination of the federal income tax and to provide rebates for all taxpayers could be as high as 35 to 50 percent. Combined with state and local sales taxes, the rate could easily exceed 50 percent in some states — and would be even higher if state income taxes were also eliminated. (See Strauss 1997; Fox and Murray 2005; and Gale, 2005.) It is doubtful that a retail sales tax that high could be collected.

Fifth, eliminating the income tax would also mean eliminating the tax-favoured status of charitable contributions, mortgage interest, state and local securities, and retirement savings.

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21 The most visible proposal is by a group called Americans for Fair Taxation; see the Internet web site: www.fairtax.org. See also Boortz and Linder (2005), which has become a best seller.

Finally — and this may be "whistling past the graveyard" — one hopes that Congress would not be irresponsible enough to adopt a proposal that would so seriously disrupt the international system.

For essentially the same reasons, I do not believe that Canada should — or would — replace its federal tax system with a sales tax. Such a policy would be quite regressive, it would leave the Canada Revenue Agency intact, unless provincial income taxes were also eliminated, and it would create unrealistic aggregate sales tax rates, especially if provincial income taxes were also eliminated. It is not an idea whose time has come on either side of the border.

Introducing a Supplementary Federal Sales Tax

The United States is the only industrialized country that lacks a national sales tax. Over the years, many have suggested that it should introduce a VAT, using the revenues alternatively to reduce the federal budget deficit (McLure 1987), to fund health care and other expenditures (Avi-Yonah 2005), or to reduce income taxes, perhaps by allowing income tax exemptions for all but the most affluent (Graetz 2002; 2005). Only the last two possible uses of revenues seem relevant in the present budgetary context. The staff of the Advisory Panel on Federal Tax Reform (United States 2005b) estimates that a 10 percent sales tax levied on a broad base would allow elimination of the alternative minimum tax and a 50 percent reduction in individual and corporate income tax rates.

To the extent that the income tax discourages saving, using VAT revenues to reduce income tax rates would be a move in the right direction, although, as noted above, any stimulus to saving is likely to be rather slight. Such a shift would also make the United States more competitive and help its balance of payments — at least until exchange rates adjust — as it would substitute a destination-based sales tax for part of the source-based income tax. Moreover, it would reduce the amount of foreign taxes that US multinationals could credit against their US tax liabilities, increasing excess foreign tax credits, making the US income tax function more like a territorial system, and further improve the country's competitive position. This option would also create incentives for income shifting to take advantage of the new constellation of income tax rates.

It has often been observed that US liberals dislike the idea of a VAT because it is regressive, while conservatives fear that a VAT would be a "money machine" — that it would be so easy to use a VAT to raise revenues that government spending would reach undesirable levels. Indeed, Larry

Summers once famously observed, before becoming Secretary of the Treasury, that the United States would enact a VAT only when conservatives learn that it is regressive and liberals learn that it is a money machine.

I share the concern that a VAT would be a money machine, but I do not believe that the oft-cited fact that the ratio of taxes to gross domestic product is higher in Europe than in the United States is dispositive. My guess is that Europeans simply want more public spending than Americans do and use the VAT to finance it. Indeed, conservative columnist Bruce Bartlett (2005), a long-time opponent of a VAT, has recently come out in favour of such a tax precisely because it is a money machine, which he believes the United States needs to reduce its large federal budget deficits.

As to the objection that a federal VAT would "poach" on the fiscal preserve of state and local governments, while I share the concern of state and local governments, I wonder whether enacting a VAT would seriously undermine the US system of federalism. The existence of a federal VAT could also assist in the administration of state and local sales taxes (see McLure 2005).

A proposal of Yale University Law School's Michael Graetz has considerable merit, provided it "adds up" (see Graetz 2002; 2005). He would raise the personal exemption to US$100,000, thereby eliminating the need for more than 80 percent of individuals to file tax returns, and he would reduce the rates of both individual and corporate income tax to about 25 percent. He would make up the lost revenue by introducing a credit-method VAT levied at a rate in the range of 10 to 15 percent. Low-income relief now provided by the earned income tax credit — the most important income support program outside of Social Security — would be implemented through the payroll tax system, by providing exemptions and making the taxes refundable.

Graetz's proposal would not produce much simplification, however, unless the states that impose income taxes were also to introduce similar exemptions and, presumably, raise — or, in some cases, introduce — sales taxes to recover lost revenues. In that event, aggregate (federal-state-local) sales tax rates could exceed 25 or even 30 percent in some states — a relatively high figure by international standards.

If the United States were to substitute revenues from a federal VAT for part of its income tax, it might be advisable for Canada also to shift toward somewhat greater reliance on indirect taxation, in order to reduce its own income tax. Of course, Canada need not adopt the Graetz plan, even if the United States were to do so, but doing so might be attractive on its own merits.

Replacing the Income Tax with a Consumption-Based Direct Tax

There are several ways to impose a conceptually consistent, consumption-based direct tax, and some features of various schemes could be combined to form a hybrid. The most commonly discussed scheme is a so-called flat tax and its close relative the "X" tax — essentially a combination of the flat tax base and graduated rates for individual taxpayers.

As regards the taxation of income from capital, the original flat tax proposal presented by Hall and Rabushka (1983; 1995) includes four distinct and separable elements:

- the expensing of all business purchases;
- the elimination of financial income (interest, dividends, and capital gains) and interest deductions from the tax base of both individuals and businesses;
- the elimination of all exclusions, deductions, and credits for individual taxpayers found in current law; and
- the introduction of a single (flat) tax rate, to be applied, in the case of individuals, only to income above a tax-exempt amount.

It is because of the first two features that a flat tax is also called a consumption-based tax; as indicated earlier, this combination of features means that the METR on income from capital would be zero. David Bradford's (2005) proposal for what he calls an "X" tax is identical to a flat tax in key respects; it would, however, provide graduated rates for individuals. Because all exclusions, deductions, and credits for individuals would be eliminated, the base of a flat tax would be broad enough that the tax rate could be relatively low — somewhere in the neighbourhood of 20 percent. Since businesses and individuals with incomes above the exempted amount would be subject to the same marginal tax rate, there would be fewer opportunities than at present for tax arbitrage.

The list of simplifications and other improvements (relative to the existing US income tax) that a flat tax or X tax would make possible is truly breathtaking. It includes:

- de facto integration of individual and corporate income taxes;
- elimination of the taxation of capital gains, without the need to distinguish between capital gains and other income;
- neutrality toward financial decisions, including debt and equity finance and financial innovation;
- elimination of distinctions between types of interest payments;

- elimination of the effects of inflation on the measurement of the tax base, without the need for explicit inflation adjustment;
- neutrality toward investment decisions;
- elimination of rules governing contributions to (and withdrawals from) retirement plans;
- reduction of complications of individual filing resulting from taxation of income from capital; and
- elimination of many "timing" issues (when income is taxed and expenses are deductible).

On the other hand, net operating losses would be much more common under a flat tax than under the existing income tax, and there would be some opportunities for tax planning involving tax-exempt organizations and foreigners (see McLure and Zodrow 1990).

The introduction of international flows of capital and income — which received altogether too little attention in the original flat tax proposals and early discussions thereof — would complicate matters for a couple of reasons. First, it is assumed that a flat tax would be a territorial system — that is, that it would apply only to business activities conducted in the United States — that all interest, dividends, and capital gains from foreign investments would be exempt, whether received or realized by businesses or by individuals, and that all interest paid to foreigners, including affiliates of US businesses, would be nondeductible. There would thus be no need for foreign tax credits. Second, it is assumed that international trade would be subject to the "origin" principle — that is, that exports would not be tax exempt and that imports would not be subject to tax, rather than both being eligible for border tax adjustments, as under a VAT. Thus, transfer prices would need to be monitored.

If the United States were to adopt a flat tax, the implications for Canada and the rest of the world would be dramatic. Income earned in the United States would be subject to a METR of zero, well below that in Canada. Perhaps more troubling than the likely effects on the location of real investment is that a significant incentive would be created for multinational enterprises to shift borrowing from the United States to countries where it would be deductible, and to realize interest income in the United States, where it would be exempt. Indeed, with a US tax rate as low as 20 percent, there would be an incentive to manipulate transfer prices to shift deductible expenses of all types out of the United States and to shift taxable income in. Such shifts could have quite detrimental revenue implications for Canada.

I believe it unlikely that the United States will adopt the flat tax in its pure form — that is, with a flat rate — because of the distributional conse-

quences. Besides eliminating tax on those with incomes below the tax threshold, a flat tax would also drastically reduce tax on the very wealthy, aggravating the growing income inequality of the past several decades. The staff of the Advisory Panel on Federal Tax Reform estimates that those with incomes in the top quintile would see their taxes reduced by close to 10 percent, and reductions for those in the top 1 to 5 percent of taxpayers would be greater still. At the same time, all other taxpayers, except those in the bottom quintile, would see tax increases ranging from almost 15 percent for those in the fourth quintile to more than 50 percent for those in the second quintile.[22]

One could, of course, eliminate these distributional effects by sacrificing the rate schedule that gives the flat tax both its name and some of its attractive economic and administrative features — that is, by substituting a graduated rate schedule, as in the X tax. Robert Hall, one of the creators of the flat tax, has recently acknowledged that

> many people now feel — with the dramatic widening of the distribution of consumption over the past three decades among American families — that this single-rate tax schedule does not distribute the tax burden fairly enough. It puts too much of the burden on the middle class and too little on the prosperous.... A tax design to fit the times might have two or even three different tax rates at the personal level. (2005, 75.)

Substituting rates of, say, 15, 25, and 35 percent for the revenue-neutral 21 percent flat rate would substantially ameliorate, but not eliminate, the shift in tax burdens among quintiles.

For individual US taxpayers, the simplicity of both a flat tax and an X tax would result primarily from two features: the elimination of tax on capital income and the disallowance of many personal deductions, including those for mortgage interest. (Individuals engaged in business would pay the business tax, which would also be simpler than the current income tax.) Since neither a flat rate nor a "clean" definition of taxable income is unique to the flat tax proposal, there is no reason that the second kind of simplicity could not also be achieved under an income tax, by eliminating deductions (see Slemrod 1995; McLure 1997). The fact that personal deductions — most notably the deduction for home mortgage interest — have not already been eliminated casts doubt on the likelihood that this crucial feature of a flat tax would be adopted. As Slemrod (2005) has said, "The prospect of eliminating all of these incentives and rewards is exhilarating to someone who seeks simplicity and beauty in a tax system, but is Pollyanna-ish to those who

22 See Feenberg, Mitrusi, and Poterba (1997); Mieszkowski and Palumbo (2002); and United States (2005b).

understand the American political system and the rewards showered on those politicians who control the dispensation of these goodies." If deductions were not eliminated, tax rates would need to be substantially higher, on average, than in the original proposal, and they might also need to be graduated. The Advisory Panel on Federal Tax Reform (United States 2005b) estimates that retaining the most important tax expenditures would necessitate tax rates of 18 percent, rather than 15 percent; 30 percent, rather than 25 percent; and 42 percent, rather than 35 percent. In short, the system might disintegrate.

Moreover, if mortgage interest were to remain deductible, there would be enormous opportunities for arbitrage by incurring deductible mortgage interest on a loan secured by a residence and using the proceeds to make investments that paid tax-exempt returns. These opportunities would be greater for high-income taxpayers under an X tax than under a flat tax, because marginal tax rates would be higher. It might be possible to close this gap, but not simply.

The most important other features of the current income tax that favour saving are those for retirement saving and the interest on debt of state and local governments. Many believe that these should be preserved, but the only way to provide preferential tax treatment for retirement saving and municipal bonds in a system in which all capital income is exempt is to subsidize them explicitly. Besides being questionable on policy grounds, such a response would create additional opportunities for arbitrage and necessitate a further increase in tax rates. Also, rules that are at least as tough and as complicated as those in current law might be required to limit the availability of tax benefits for retirement saving by high-income individuals. So much for Hall and Rabushka's (1983) "Low Tax, Simple Tax, Flat Tax."

The existence of state and local taxes further complicates matters. Unless state and local tax bases conformed to that of a flat tax or X tax, there would be little if any simplification. Rather, the tax administrations of the 45 states that impose income tax would have to monitor interest income and expenses themselves, since the IRS would not longer need to do so.

There is, in addition, an international issue that would cause pause. World interest rates likely would not fall enough to reflect fully the fact that interest would be exempt and nondeductible under a US flat tax. Entities that can borrow abroad would still be able to deduct interest expense, and thus to engage in arbitrage. But smaller firms trying to borrow abroad would find debt-financed investment substantially more expensive than under the current tax regime.[23]

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23 The Mintz Report also made this point; see Canada (1998).

One can imagine a "blended" system in which the United States continued to levy both the existing income tax and a flat tax or X tax, perhaps as a transition stage on the road to sole reliance on the flat tax or X tax. In such a scheme, each tax could have its own rate schedule, or tax rates could be applied to the total of the two tax bases. Most of the economic effects just described, both good and bad, would be muted. The inconsistency of the two tax bases might not create significant compliance and administrative problems, as implementing the taxes, at least in their pure forms, would involve merely neglecting figures for financial flows and deductions that would otherwise have appeared on the income tax return and, for businesses, using expensing.

Whether or not the United States were to adopt a flat tax, Canada might well consider doing so, either as a defensive measure or as part of a program to reduce the heavy tax burden on income from capital. As in the United States, it seems unlikely that Canada would adopt the flat-rate version of a flat tax. And Canada would also find it necessary to reduce politically popular personal deductions, in order to keep tax rates down. At the same time, however, Canada differs from the United States in two important respects that bode well for adopting the base of a flat tax. First, mortgage interest is not deductible in Canada, which would mean one less political roadblock to adopting a flat-tax treatment of interest income and expense. Second, interest on the debt of provincial and local governments is not tax exempt. Canada would, however, face the same dilemma as the United States of what to do about tax benefits for retirement saving.

Replacing the Income Tax with Other Kinds of Consumption-Based Taxes

A flat tax is one kind of consumption-based tax, but there are also other ways to design such a tax. Two examples are a post-paid, consumed-income tax and a hybrid that combines elements of a flat tax and a consumed income tax. Also a business income tax that does not include expensing is possible. I touch on these alternatives only briefly, as none is gaining much attention in the United States and I have no reason to think they would be more popular in Canada.

A Consumed-Income Tax

Unlike a flat tax, which ignores financial transactions, a consumed-income tax includes such transactions in its base. A consumed-income tax was ana-

lyzed by the US Treasury Department in the late 1970s, but it has garnered few advocates. Indeed, one group that initially favoured a form of consumed-income tax called an Unlimited Savings Allowance (USA) Tax (see Weidenbaum 1996) has shifted its support to a tax-prepaid system, in part because the proposal reflected an attempt to preserve too many of the incentives that the current income tax provides, and it would have treated lending and borrowing inconsistently.

A Flat Tax/Consumed-Income Tax Hybrid

Taxation of individuals clearly would be simpler under a flat tax than under a consumed-income tax. Under a flat tax, interest and other income from financial investments would be exempt and interest expenses nondeductible; by comparison, a consumed-income tax would require the maintenance of records concerning saving and dissaving (see McLure and Zodrow 1990). Moreover, many people would likely see as unfair the inclusion of borrowing — for example, an increase in credit card debt — in the base of a consumed-income tax. While my colleagues and I were preparing the Treasury Department's 1984 tax reform proposals to President Ronald Reagan, I recalled the old joke about a simple, two-sentence tax return: "How much did you make this year? Send it in." To make the point, I modified the joke by adding two more sentences: "How much did you borrow? Send it, too." On the other hand, the way a flat tax treats business is also problematic. One glaring political problem is that the entire margin of banks and other financial institutions would escape tax under such a system. It would be possible, however, to combine flat-tax treatment of individuals with cash-flow treatment of businesses to create a hybrid, although, to my knowledge, this idea has not gained traction in Washington.[24]

A Comprehensive Business Income Tax

In the waning days of the administration of the first President Bush, the US Treasury Department proposed that the current taxation of business income be replaced by a Comprehensive Business Income Tax (CBIT) (see United States 1992). The key features of this proposal were the disallowance of deductions for interest expenses, the exemption of interest income, and the elimination of tax on dividends and many capital gains. The base of such a tax would be quite similar to that of a flat tax or an X tax, except that the cost

24 For more on the rationale and benefits of a hybrid system, see McLure and Zodrow (1996).

of capital investment would continue to be recovered through depreciation and similar allowances, rather than through expensing. Thus, the aggregate tax base, considering both the individual and business tax elements, would be income, rather than consumption. Like a flat tax and an X tax, a CBIT would convert the individual income tax into primarily a tax on labour income, as interest would be taxed at the business level, via the disallowance of deductions, rather than at the individual level. The tax treatment of interest and dividends would also be equalized, thus eliminating the existing preference for debt finance.

One of the problems of a CBIT, however, is that it would equalize the tax treatment of debt and equity in a manner inconsistent with current international practice, which is based on deduction of interest expenses. Thus, the Treasury Department acknowledges (United States 1992, 48) that such a tax would require "extensive international discussions with tax authorities and market participants." Indeed, one could make the same comment about most of the proposals for radical reform discussed above.

Ad Hoc Muddling Through

The current Bush administration has shown a strong proclivity to advocate ad hoc adoption of components of a consumption-based tax — such as bonus depreciation and reductions in the taxation of dividends and capital gains — without doing anything to limit the deductibility of interest. It would not be surprising to see this trend continue. For example, the tax on dividends and capital gains might be eliminated, there might again be a move toward expensing, and a scheme might be enacted to provide preferential treatment for all saving.

Such a development would be unfortunate, since, as noted above, the US tax system collects virtually nothing from the taxation of capital income. This suggests that ad hoc-ery has gone too far, since substantial amounts of capital income — namely, above-normal profits, the return to risk taking, and the fruits of good fortune — would be taxed under a conceptually pure consumption-based tax.

The loss of revenue is not, however, the only problem inherent in an ad hoc approach. As Zodrow (2005) writes in a recent review of the economic case for consumption-based taxation,

> piecemeal reforms that cobble together various elements of a consumption tax reform, but do not include all of its features including especially the elimination of interest deductibility, can be highly undesirable. In particular, allowing expensing and exempting capital income from taxation

> at the individual level without providing for consumption-based tax treatment of interest expense loses revenue while not gaining the advantages of consumption-based taxation in providing uniform tax treatment of all saving and investment decisions and a simplified tax system.

The implications for Canada are clear: it should not follow the United States further down the road to an ad hoc system that is neither an income tax nor a consumption-based tax.

Concluding Remarks

Considering the recommendations of President Bush's Advisory Panel on Federal Tax Reform, the likelihood of their being enacted, and other things that may come out of Congress, it seems safe to say that, although Canada should pay attention to what is happening south of the border, it need not panic.

The United States is highly unlikely to replace its entire federal income tax with a retail sales tax. That it might replace part of the revenues from the income tax with a VAT seems somewhat more likely, but still a long shot. In its pure form, a flat tax probably would face insuperable opposition, especially once middle-class taxpayers who think they would like a flat tax realize they would pay higher taxes so the rich can pay substantially less. A flat tax with graduated rates — an X tax — would not face that objection, but it still would represent such a radical break with the past that its enactment would be far from assured. Thus, the most likely result is marginal changes in the income tax that do not depart far from historical precedents — what I have called *ad hoc* muddling through.

If the United States were to reduce somewhat both statutory tax rates and marginal effective tax rates on income from capital, as seems likely, Canada might want to follow suit. Even if nothing else happened, lower statutory tax rates in the United States would partially deplete Canada's tax base, as multinational enterprises adjusted to minimize taxation of their income and maximize the value of deductions. But if US effective tax rates fell, something else probably would happen: unless Canada responded, the United States *would* become a more attractive location for many economic activities that can be sited in either country.

So, how should Canada respond? First, it should reduce corporate income tax rates. Second, it should take steps to reduce marginal effective tax rates on income from capital, including reassessing depreciation allowances and inventory accounting, eliminating all capital taxes, and removing business purchases from the base of its provincial sales taxes. Finally, I see no

good nonpolitical reason that provinces with outmoded retail sales taxes should not abandon them in favour of value-added taxes, which would automatically eliminate tax on capital goods. (For similar conclusions, see Kesselman 2004.)

Canada should undertake these reforms even if the United States does nothing to reduce its taxation of income from capital. Taxes on capital and sales taxes on business inputs are wrong-headed policies, no matter what the United States does, and no nation should continue with them.

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